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What Are the Tax Reasons Favouring the United Kingdom as a Holding Company Location for International Groups?

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Recent activity in the merger and M&A space has drawn attention to the United Kingdom as a potentially attractive location for a holding company of a multinational group.

Recent Transactions

The proposed structure for the merger of the Omnicom and Publicis U.S./French advertising businesses, the collapse of which was announced last week, was based on a UK tax resident (Dutch incorporated) holding company.

One of the reported benefits to Pfizer of its hostile takeover bid for AstraZeneca is said to be the effective tax “redomiciling” of the Pfizer parent company away from the United States to the United Kingdom.

Various commercial factors will influence the choice of holding company location and tax is by no means the sole or most important one. However, insofar as tax is relevant, the UK government’s stated ambition is to create the most competitive tax system in the G20 and specifically to make the United Kingdom the best location for corporate headquarters in Europe.

Tax-Efficient Dividend Flows

The profits of the underlying operating companies will, of course, remain fully taxable in the locations where they are formed and/or carrying on business, in accordance with local law.

However, the combination of extensive relief from foreign withholding tax, exemption from UK tax on dividend receipts, and the absence of UK withholding tax on outbound dividends, as outlined below, means that it is possible for distributions of profits from operating subsidiaries in many foreign jurisdictions to flow through the United Kingdom. efficiently with no, or minimal, *incremental* tax cost, either on the repatriation of the profits or on their onward distribution to shareholders.

Exemption for Incoming Dividends

Most dividends received in the UK will be free of UK corporation tax, even dividends from low-tax/passive subsidiaries.

A number of "classes" of dividend payment are tax exempt, provided the dividend payment is not tax deductible in the source jurisdiction (and certain specific anti-avoidance exclusions do not apply).

The most relevant classes of exempt dividend, none of which have a minimum holding period, are:

- dividends paid on shares of any kind where the UK recipient controls (or jointly controls) the payer, in terms of powers or economic rights;
- dividends paid on non-redeemable ordinary shares – there is no minimum shareholding size;
- dividends paid on shares of any kind where the recipient (together with connected persons) holds less than 10% of the issued share capital of the paying company (or less than 10% of the class of shares held, where there is more than one class in issue); and
- dividends paid on shares of any kind, where the profits are not derived from transactions designed to achieve a reduction in UK tax.

The dividend exemption was introduced in 2009 in place of a foreign tax credit regime. The credit rules have not been removed entirely, and remain as the default regime, which applies where dividends are not exempt or where the taxpayer elects for the credit regime. Under that regime, the foreign dividends are taxed (currently, at 21% and, from 1 April 2015, at 20%), but with credit both for any withholding tax and for the local tax charged on the profits out of which the dividend is paid. Given the low rate of UK corporation tax compared with many foreign corporate tax rates, these credit rules will often give complete relief from UK tax on dividend receipts. So, the availability of the exemption may not have any impact on the group's effective tax rate (compared with the alternative credit regime) but it is more predictable and simpler to self-assess.

Reduced Withholding Tax on Dividends from Foreign Jurisdictions

UK companies can receive dividends from foreign subsidiaries free of local withholding tax, in accordance with the EU Parent/Subsidiary Directive, if those subsidiaries are located within the European Union.

For dividends received from subsidiaries outside the EU, foreign withholding tax on the incoming dividends can be reduced by the United Kingdom's extensive tax treaty network. The relative advantages of different holding company jurisdictions need to be assessed on a case-by-case basis, depending on the location of the group's operations and the detailed provisions of the relevant treaties. However, in terms of the sheer size of its treaty network, with around 112 active tax treaties, the UK compares well with other well-known holding company jurisdictions, including (for instance) Ireland, Luxembourg, the Netherlands, Malta, Singapore and Switzerland.

In both cases, relief will be subject to meeting any "anti-conduit" type anti-avoidance conditions.

No United Kingdom Withholding Tax on Outbound Dividends

The United Kingdom does not levy withholding tax on dividends, share buybacks or liquidation distributions paid by UK companies.

Controlled Foreign Company Regime

Even if the incoming dividends are not taxable, one still needs to consider whether the *undistributed* profits of the subsidiaries (particularly those located in low-tax jurisdictions) could be taxed on the UK parent company under the controlled foreign company (**CFC**) regime.

A completely new CFC regime was put in place with effect from 1 January 2013. The current rules are designed to target more accurately profits which have been artificially diverted away from the UK.

Framework

The starting point is that the CFC regime applies to companies resident outside the UK which are controlled by UK residents. Similar rules will apply to exempt foreign branches of UK resident companies.

Only those profits of foreign subsidiaries which pass through a charge "gateway" are potentially taxable.

A CFC charge arises if:

- the CFC has "chargeable profits", meaning, essentially, income profits that pass through the gateway;
- none of the entity-level exemptions apply;
- there is a UK person that holds an interest in the CFC, that is not exempt (e.g. certain offshore funds and share traders) and that, together with connected companies, holds an interest of at least 25%.

It is not necessary to work through the conditions in order. For example, if one of the entity-level exemptions applies, it is not necessary to consider whether or not the CFC has any chargeable profits. These entity-level exemptions relate to "exempt periods" (for foreign companies becoming CFCs for the first time, for example by reason of takeover or migration), "excluded territories" (for CFCs resident in certain territories, subject to conditions), "low profits" (for CFCs with low levels of profit), “low profit margin” (for CFCs whose profit is a small margin above certain defined expenditure) and “tax exemption” (for CFCs that pay at least 75% of the tax they would have paid if UK resident).

If a CFC charge arises, there is a UK corporation tax liability on each chargeable company holding a relevant interest in the CFC, on the relevant proportion of the CFC’s chargeable profits.

Initial and Main Gateways

A feature of the legislation is an initial filter. This applies by reference to various different categories of profit. If certain profits pass through the initial filter for the relevant category, then the more detailed applicable “main gateway” rules for that category need to be examined. Only if they pass through the main gateway as well, will they constitute “chargeable profits”, potentially triggering a CFC charge. If the initial filter for a particular category filters out the relevant profits of the CFC at that stage, then there is no need to look at the more detailed main gateway rules for that particular category.

However, the various profit categories are not mutually exclusive. In other words, even if a particular item of profit does not pass through the initial (or main) gateway under one heading, it might pass through under another.

Gateway – Trading Profits – UK Management

A subsidiary’s trading profits potentially fall within the first main category of profits.

The initial gateway for this category does not let through trading profits if the CFC does not have any UK-managed assets or bear any UK-managed risks. This test examines whether the acquisition, creation, development or exploitation of the asset or the taking on, or bearing, of the risk, is managed or controlled to any significant extent by way of activities carried on in the UK, either by the CFC itself (otherwise than through a UK permanent establishment) or by companies connected with the CFC under arrangements which would not, it is reasonable to suppose, be entered into by companies not connected with each other.

The basic concern is that a CFC is being used to divert profits from the United Kingdom by separating the assets and risks from the associated group activity, and that the CFC would not be capable of managing the business on its own without loss of commercial effectiveness.

There is an allowance for any UK activities which one might reasonably suppose would otherwise have been outsourced to an unconnected company. Her Majesty’s Revenue and Customs (**HMRC**) say that this is aimed at the sort of situation where the nature of the services or the degree of control and/or access to information required is not such that it would be reasonable to assume that such support and/or services could have been provided by, or given to, an unconnected person.

Helpfully, HMRC’s draft guidance indicates that the CFC’s assets or risks would not be regarded as “UK managed” simply because a UK parent company carries out oversight or group governance functions; for example, by setting parameters according to which the business of overseas group companies must be conducted or adopting a strategy or business plan for the group. As long as "active, day to day decision-making" in respect of the assets and risks does not take place in the UK, they would not be "UK managed". If a group is relying on this distinction, care should be taken to make sure that the CFC is doing more than simply "rubber stamping" a decision which has really been taken in the United Kingdom.

In addition, the draft guidance says that guidance or advice on specific matters could be given to a CFC from the UK, provided that the CFC's staff had the skills and capacity to understand and evaluate the guidance and make appropriate decisions that take account of it.

On the face of it, it does not seem that there should be many instances where a trading subsidiary will fall foul of the initial gateway, without having triggered another UK tax problem in any case. If, in fact, contrary to standard operating guidelines for a foreign subsidiary, the CFC's assets and risks are being managed and controlled from the UK, then in most situations the profits will effectively fall within the scope of UK corporation tax anyway, without the need for HMRC to resort to the CFC regime:

- this could be because the CFC itself is chargeable to UK tax, on the basis that the CFC is trading in the UK through a permanent establishment, either through its own employees or though a dependent agent;
- alternatively, where the support or services being provided from the UK are significant, the UK transfer pricing rules are likely to result in a significant proportion of the gross income arising from such activities being deemed to be payable to the UK affiliate as an arm's length fee, which fee would be taxable in the hands of the UK service provider.

During the early stages of the lengthy consultation period, there were many representations querying the need for a CFC regime at all, for the above reasons. HM Treasury rejected the idea that they could dispense with a CFC regime altogether but, as the draft guidance acknowledges, these other mechanisms for protecting the UK tax base take priority.

One situation where the CFC regime might pick up an artificial diversion of profits from the UK, which would otherwise not be caught by the permanent establishment or transfer pricing rules, could be a situation where the CFC relies on a combination of several different UK connected companies to provide key services, which in aggregate amount to its assets and risks being managed and controlled from the UK.

Another might be where the kind of services provided to the CFC by UK affiliates are not, by their nature, suitable for third party outsourcing. In that situation, it might be difficult to compute the correct transfer price on arm's length principles.

Gateway – Trading Profits – Motive Test

Alternatively, the initial gateway for the main category covering trading profits does not let through profits if a form of motive test is met. The question is whether the CFC holds assets or bears risk under an arrangement with all three of the following characteristics:

- the main purpose, or one of the main purposes, of the arrangement is to reduce or eliminate any liability of any person to UK tax or duty;
- the consequence of the arrangement is that at any time the CFC expects its business to be more profitable (other than negligibly) than it would otherwise be;
- the arrangement gives rise to an expectation that one or more persons will have liabilities to tax or duty imposed under the law of any territory reduced or eliminated, and it is reasonable to suppose that the arrangements would not have been made if there was not that expectation.

In their draft guidance, HMRC make the comment in relation to the third feature that it would be reasonable to suppose that an arrangement would have been made if there is a clear objective expectation of commercial non-tax benefits in the arrangement as compared with other options realistically available to the CFC group and these benefits, on an objective calculation, are clearly sufficient on their own for the arrangements that have been adopted.

Gateway – Trading Finance Profits – Investment Return

A CFC carrying on a financial business will also need to consider the “trading finance profit” category, in respect of its interest, dividend and derivative trading income.

Profits in this category only pass through the initial gateway where the CFC has funds or other assets that derive (directly or indirectly) from any capital contribution to the CFC made (directly or indirectly) by a UK resident company which is connected with the CFC. It is not relevant whether that capital contribution is related to an issue of shares in the CFC.

However, there are obvious practical difficulties in tracing the source of funds of a CFC. Therefore, even in a situation where the CFC has been in business for a while (and has realised profits and paid significant dividends to its UK parent), the fact that, typically, all or part of the CFC’s initial finance was provided by the group is likely to mean that the prudent approach will be to proceed to the next step, and test whether the trading finance profits pass through the main gateway.

The main gateway test looks at the CFC’s free capital or, in the case of an insurance company, its excess free assets and asks whether the CFC has “excess free capital” or “excess free assets”. If it does, the attributable profits pass through the main gateway and are potentially taxable.

“Free capital” means the funding which the CFC has for its business and which does not have an associated cost in a form which would normally be tax-deductible, such as interest, discount or premium. In other words, “free capital” means amounts received by way of subscription for shares, free capital contributions, interest-free loans or similar. The free capital is “excess” to the extent that it exceeds what it is reasonable to suppose its free capital would be were it not the 51% subsidiary of any other company.

"Free assets" means the amount by which the value of the CFC's assets exceeds its loan capital. The free assets are "excess" to the extent that they exceed what it is reasonable to suppose its free assets would be were it not the 51% subsidiary of any other company.

There is a safe harbour for banking businesses, where the CFC's tier 1 capital ratio does not exceed 125% of the group tier 1 capital of the subsidiary's UK banking group. No corresponding safe harbour has yet been established for insurance businesses.

Gateway – Other Categories of Profits

Additional gateway rules apply to non-trading finance income and captive insurance companies. There are special rules for group finance companies.

Entity-Level Exemptions

If profits pass through the gateway, one of the entity-level exemptions mentioned above may still prevent a UK tax charge.

For example, the "excluded territories exemption" is aimed at companies which are regarded as low risk to the UK tax base, partly because of their country of residence and partly because of the types of income which they receive. There is a simplified version for companies resident in one of six countries, namely Australia, Canada, France, Germany, Japan and the United States, whereby the exemption applies if the CFC does not carry on business through a permanent establishment outside its country of tax residence and the company is not involved in an arrangement one of the main purposes of which is to obtain a UK corporation/income tax advantage for any person. This can be a straightforward "escape route" from a CFC liability for CFCs located in any of those six countries.

No United Kingdom Tax on the Sale of Operating Subsidiaries

The so-called "substantial shareholding exemption" provides a tax exemption corresponding to the capital gains tax component of the "participation exemption" in some of the popular holding company jurisdictions.

Where a UK company sells a trading subsidiary, it will not normally be subject to any UK corporation tax on the realised gain, provided the UK company has owned at least 10% of the ordinary shares of the trading subsidiary (and has been beneficially entitled to at least 10% of the distributions and assets of the subsidiary) for at least 12 months and is itself either a trading company or a member of a trading group (and will remain so immediately following the disposal).

A key requirement is that the target is a "trading company" or a "holding company of a trading sub-group" and that the UK parent is a "member of a trading group". This means that the activities of the company, group or sub-group as a whole do not comprise non-trading activities to a substantial extent (which HMRC interpret to mean more than 20%). "Trade" is distinguished from "investment" activities for this purpose. Intra-(sub)group transactions are ignored. HMRC usually look at three measures – the assets, the income and the time spent/expenses incurred by employees.

Areas where problems may arise include where profits are generated which are not required for reinvestment in the business but which are not distributed to shareholders, or where restructuring of, or developments in, the business have led to certain capital assets being redundant to current business needs.

No United Kingdom Tax on the Sale of Shares in a UK Company by a Foreign Shareholder

The fact that a group holding company is resident for tax purposes in the United Kingdom does not usually, in itself, bring any capital gain realised by a non-resident shareholder on a sale of shares in the company within the scope of UK tax.

Deductible Interest Costs

Interest costs on borrowings incurred to purchase or fund (both UK and overseas) subsidiaries are, in principle, tax deductible (subject to certain anti-avoidance rules).

The level of debt taken on, and the interest rate payable, will need to meet arm’s length standards.

The worldwide debt cap may impact upon the deduction of debt financing costs. Put simply, this rule can apply where the UK members of the group bear a greater amount of interest expense than the group as a whole is paying to external lenders. The excess interest costs are not tax deductible.

However, the regime is subject to gateway and *de minimis* tests, and contains important exemptions — including, in particular, for certain groups in the financial services sector.

Transfer Pricing and Other Tax Implications

All that being said, the suitability of the United Kingdom needs to be assessed on a case-by-case basis.

The UK is a full-tax jurisdiction with a highly developed tax system.

In particular, under UK transfer pricing rules, a UK holding company will be required to adjust its taxable profits in line with the internationally accepted arm’s length principle.

This means that it will be required to recognise an arm’s length fee for the provision of any services to affiliates (such as management and administrative services, loans or guarantees, or licences of intellectual property). Equally, expenses incurred by the UK company under arrangements with affiliates will only be tax deductible to the extent that they do not exceed an open market rate.

Depending on the facts, the UK value added tax, payroll tax, interest withholding tax, stamp duty and other tax implications may also need to be considered.

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Continued

Conclusion

Taking into account the non-tax related factors as well, it is not surprising that the United Kingdom now compares favourably with some of the traditional holding company jurisdictions for international groups.

If you have any questions regarding this memorandum, please contact Judith Harger in our London office (+44 20 3580 4705, jharger@willkie.com) or the Willkie attorney with whom you regularly work.

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